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Admassu Bezabeh
Barowsky School of Business, Dominican University of California, admassu.bezabeh@dominican.edu

Asayehgn Desta
Barowsky School of Business, Dominican University of California, asayehgn.desta@dominican.edu

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Admassu Bezabeh, Ph.D.
School of Business and Leadership,
Dominican University of California San Rafael,
California

Asayehgn Desta, Ph.D.
School of Business and Leadership,
Dominican University of California, San Rafael,
California.

Abstract

The fragile and inefficient state-dominated banking sector that existed in Ethiopia during the military government (1974-1991) was a major hindrance to economic growth. Since it took power in 1991, the current government has implemented a number of reforms. For instance, in 1994, the government legalized domestic private investment in the banking industry. In addition, it restructured the two development banks as commercial banks, and introduced a new Banking and Monetary Proclamation that gave more autonomy and further clarified the National Bank of Ethiopia's activities as the regulator and supervisor of the banking sector. Although these measures have led to marginal improvements in efficiency and competition, there is a great need for additional market oriented reforms to further enhance the sector's role in mobilizing savings and allocating funds to their optimum usage. The purpose of this paper was to analyze additional market-based policy initiatives undertaken by the government to determine if they would further enhance the efficiency of the banking sector in Ethiopia. Based on the results of the data analysis it may be concluded that the Ethiopian government needs to further strategize and take the following steps: a) reverse the decision prohibiting foreign banks from investing in the country, b) fully privatize the state-owned commercial banks, c) allow market forces to determine interest rates and the exchange rate of the Ethiopian currency, Birr (ETB), and d) upgrade the regulatory and supervisory capacity of the National Bank of Ethiopia to facilitate efficiency in the banking market.

Key words: *state-dominated banking, efficiency, competition, foreign banks, market forces, exchange rate*

1. Introduction

In order to accelerate the economic growth process, the current government of Ethiopia has embarked on a number of reforms to improve the efficiency and competitiveness of the banking sector. Reform measures undertaken by the government to date include addressing the wide-spread problem of non-performing loans experienced by state owned banks; reconstituting both the Development Bank of

Ethiopia and the Construction and Business Bank as commercial banks; opening up the banking sector to private domestic investment; and introducing a new banking act to give more autonomy to the National Bank of Ethiopia. The key provisions of these reforms in the Ethiopian banking services were mainly tailored to expanding customer access, improving efficiency and encouraging competition. Although the banking sector has grown somewhat since 1994 when the above stated reform measures were implemented, thus far the banking sector still remains monopolistic, inefficient and is incapable of improving the intermediation of private sector savings. As a consequence, the contribution of the banking system to facilitating the economic growth of Ethiopia is marginal.

This article investigates how the above-mentioned four market-based reforms could result in efficiency and promote the competitive position of the Ethiopian banking sector. The second section briefly narrates the characteristics of the banking sector in Ethiopia. Section three summarizes studies that relate the association between financial lending institutions and economic growth. The fourth section gives a summary of the banking policy reform measures introduced by the current Ethiopian government. Finally, section five summarizes the conclusion of the paper and proposes some market-oriented reforms needed by the Ethiopian banking sector to make it more efficient and competitive in the global market.

2. Characteristics of the Banking Sector in Ethiopia

Currently, the banking sector in Ethiopia is in a rudimentary and fragile state. It is small, relatively undeveloped, closed and characterized by a large share of state ownership. The state- owned commercial banks account for nearly two-thirds of the banking sector assets. Such extensive state presence in the banking sector coupled with total state ownership of land and telecommunications, as well as majority government ownership in many sectors of the economy have serious ramifications for private sector development in Ethiopia.

The government continues to implement repressive policies that negatively impact the performance of money and foreign exchange markets and weaken private commercial banks. In addition to controlling interest rates on deposits, the government interferes with the credit allocation decisions of private banks. Credit is often rationed in favor of larger and more established businesses. In fact, the World Bank's assessment demonstrates that state-owned enterprises have much better access to credit than private businesses (World Bank, June 2009). The state-owned Development Bank of Ethiopia only lends to support the government's industrial development initiatives, selectively providing capital to firms in sectors the government wants to promote. Moreover, the National Bank issued a directive on April 6, 2011 ordering private commercial banks to buy government bonds worth 27 percent of the loan disbursements they have made since July, 2010. This measure was set to earn 3 percent interest while the deposit rates set by the National Bank stand at 5 percent (Ethiopian Bank, July, 2010).

Furthermore, securing a loan requires high collateral, putting younger and smaller businesses at a disadvantage. Without access to capital they cannot afford the investments necessary to grow. This development ends up protecting underperforming large and medium-sized firms. Moreover, the extent of financial repression has contributed to negative effects on savings, capital formation and financial development.

Proclamation No. 84/1994 that allowed the private sector to engage in the banking business marked the beginning of a new era in Ethiopian banking. Following this proclamation Ethiopia witnessed a proliferation of domestic private banks. At present there are fourteen private banks with a total of 394 branches. Ethiopia's private banks registered very strong growth in 2010 in all three banking operations: mobilizing deposits, providing loans, and dealing in foreign exchange (Ethiopian Government, Proclamation No. 84/1994).

Table I: Summary Indictors for Ethiopia's Private Banks

All Private Banks	2009	2010	Growth Rate (%)
Deposits (ETB millions)	29,864	38,339	28.4
Loans (ETB millions)	17,661	21,385	21.1
Foreign Assets (USD millions)	252	570	126.4
Total Assets (ETB millions)	39,683	50,571	27.4

Source: Banking Sector Review 2010, Access Capital Research, December 2010

According to Access Capital Research, return on average equity and average assets for private banks in 2010 were 22.2 percent and 2.4 percent respectively (Banking Sector Review, December, 2010). However, despite the impressive growth of deposits, loans and profits the private banking sector has had several challenges. First, the interest rate offered to depositors was set by the National Bank. It was held at an abysmally low rate of 4 percent until it was revised to 4.5 percent despite an inflation rate of an average of 19 percent during the period 2005 - 2010. With the government's decision to fix the deposit rate at 4.5 percent on the one hand and galloping inflation on the other made the government's goal of achieving positive real interest rates out of reach. Second, domestic private banks did not offer loans with long maturities limiting their usefulness to the agricultural and manufacturing sectors of the economy. Almost all of their loans have maturities of less than five years and about three-fifth of the loans are short-term loans. Third, the payment system is devoid of technology. The long delay in processing checks remains a significant problem facing banks and their customers in Ethiopia.

The banking sector in Ethiopia has been dominated by the state-owned Commercial Bank of Ethiopia (CBE). In 2010, CBE alone held approximately 63.5 percent of deposits and 38 percent of bank loans in the country. Also, its total assets amounted to ETB 73.7 billion, equal to 65 percent of all bank assets in Ethiopia. CBE's branch network consists of 366 branches equal to 48 percent of all bank branches in the country. During 2010 alone it established 111 branches, surpassing the annual target of 100 branches its management set for itself (Banking Sector Review 2010). The opening of these new branches significantly contributed to the mobilization of additional deposits.

The level of financial intermediation in Ethiopia is low**,** in part due to the public's lack of confidence in the banking sector. This in turn is due to a very weak supervisory framework, dominant state ownership, and its widespread lending directed by the National Bank of Ethiopia (NBE). Moreover, the non-performing loan problem that was widespread among government owned banks in the early 1990s was contributing to their insolvency. The factors that led banks to insolvency were mismanagement, ineffective supervision, and political interference with credit decisions. Unfortunately, all of these three major contributing factors were in play in Ethiopia during the transition period.

3. Literature Review

The different points of view held by economists regarding the relationship between financial development and economic growth can be broadly classified into four perspectives. The supply-side states that financial development has a positive effect on economic growth. Joseph Schumpeter (1912) states that well functioning banks spur technological innovation by indentifying and funding those entrepreneurs with the best chances of successfully implementing innovative products and production processes.

John Hicks (1969) argues that financial development played a critical role in igniting industrialization in England by facilitating the mobilization of capital. According to this view, financial intermediation contributes to economic growth through two main channels. The first as stated by Goldsmith (1969) is that financial intermediation raises the efficiency of capital accumulation and in turn maximizes the marginal productivity of capital. The second as outlined by McKinnon (1973), Shaw (1973), and Fry (1997) is by raising the savings rate and thus the investment rate. According to these authors, increasing the size of savings and improving the efficiency of investment, financial development leads to higher economic growth. This view has gained support from empirical studies conducted by Thakor (1996), Bencivenga and Smith (1991), Greenwood and Jovanovic (1990).

According to supply-side adherents financial liberalization enhances economic efficiency and growth. An improved financial system fosters the efficient mobilization of domestic savings and allocates resources to their optimum usage. Also, a higher degree of competition and efficiency in the banking sector can contribute to greater financial stability, product innovation, and access of households and firms to financial services, which in turn can improve the prospects for economic growth. In contrast, financial repression discourages savings and contributes to misallocation of credit. When governments set interest rates below the free-market rate, the public sector and well-connected customers tend to receive credit at more favorable terms than small-scale entrepreneurial firms that have to obtain funds in expensive informal credit markets. The state- dominated, monopolistic banking sector is inefficient and thus a major hindrance to economic growth.

On the other hand, Joan Robinson (1952) views that where enterprise leads finance follows. According to this view, as the economy expands, its demand for financial services increases, leading to the growth of these services. Empirical support for this demand-side view is provided by Demetrides and Hussein (1996), Ireland (1994) and Friedman and Schwartz (1963).

A third perspective of the relationship between financial development and economic growth postulates that the two variables are mutually causal. As stated by Greenwood and Smith (1997), the two variables have bidirectional causality. Finally, the fourth perspective though not as widely held as the other views, states that financial development and economic growth are not causally related (Lucas (1998).

The empirical work linking financial development and economic growth has been extensive. For example, King and Levine (1993) show a strong positive link between financial development and economic growth based on their study covering a cross section of 80 countries. McKinnon (1973) studied *the financial system and economic development in several countries and concluded that better functioning financial systems support faster economic growth. It is therefore paramount to identify and implement reform measures that can enhance the efficiency of the banking sector and promote its competitiveness to accelerate Ethiopia's economic growth.*

Although the debate regarding causality between financial development and economic growth continues, Levine (1997), based on the preponderance of theoretical reasoning and empirical evidence, concluded that a positive first-order relationship exists between financial development and economic growth. In fact a growing body of work provides evidence that the development of financial markets and institutions is a critical and inextricable part of the growth process. Again according to Levine (1997), "the level of finial development is a good predictor of future rates of economic growth, capital formation and technological change." Based on cross-country analysis, Levine (1997) further points out that "financial development – or the lack thereof affects the speed and pattern of economic development."

4. Policy Measures Introduced by the Government

During the military rule in Ethiopia, the banking sector was riddled with non-performing loans as a consequence of weak lending practices. For instance, the non-performing loans of the Commercial Bank of Ethiopia amounted to ETB 5.8 billion, equivalent to 59 percent of its total annual loan portfolio at the end of June, 2002. Similarly, the non- performing loans of the Development Bank of Ethiopia reached 94 percent in 2003 (Banking Sector Review 2010). The factors that led these two banks to accumulate massive amounts of non-performing loans and eventually to their insolvency were mismanagement, ineffective supervision and political interference. All of these factors were at play in Ethiopia during the early years of the current administration.

Abiding by the first perspective that there is a strong positive relationship between financial development and economic growth, in the early 1990s, the Ethiopian government implemented several measures to reform the banking sector's competitiveness and efficiency and thereby enhance the country's economic growth. Initially, efforts of the government were focused on cleaning up these non-performing loans by restructuring and recapitalizing the Development Bank of Ethiopia. Regarding the longer-term, according to the Memorandum on Economic and Financial Policies for the period July 8, 2003 – July 7, 2004 dated July 23, 2003, the following measures were taken. First, the Construction and Business Bank (CBB) was brought to the point of sale through the floatation of all of its shares to the Ethiopian public. However, the offer was withdrawn due to lack of audited accounts. Second, the government decided to finalize the financial restructuring of the Development Bank of Ethiopia (DBE) by end of 2003.Third, with respect to the Commercial Bank of Ethiopia (CBE), an independent audit was carried out according to International Accounting Standards by KPMG. The audit found that non-performing loans of the bank amounted ETB 5.8 billion, equivalent to 59 percent of total loans at the end of June, 2002. The audit recommended that the issue of non-performing loans be addressed and actions taken to restore the profitability of the bank. The audit further recommended that credit risk and portfolio management be significantly strengthened.

Again according to the same Memorandum, the following measures were taken to minimize the risk of new non-performing loans emerging:

- Ceasing all lending to borrowers with non-performing loans;

- Strengthening the credit approval and monitoring process for all new loans;
- Transferring lending authority from the board of CBE to its management;
- Giving autonomy to management in decision making;
- Creating an audit committee of the board to oversee financial performance; and
- Implementing the revised foreclosure law to speed up its application and improve its effectiveness.

Moreover, as part of the restructuring plan of CBE, credit risk and portfolio management were significantly strengthened. The key elements of the plan according to the memorandum included the following:

- Ensuring that CBE complied fully with the NBE provisioning directives by January 2004;
- A time bound plan for reducing non-performing loans to 20 percent of the total loans; and
- Assuring that the capital adequacy ratio will not fall below the minimum required ratio of 8 percent, and promptly recapitalizing the bank should the ratio fall below 8 percent.

In addition, as part of the restructuring plan, the modalities and timetables for resolving non-performing loans were set out clearly. No annual dividends would be paid out by the CBE until the capital adequacy ratio reached 10 percent and a business plan was prepared to achieve this target by June, 2004.

Fourth, the government issued Proclamation No. 591/2008 dated August 11, 2008, in order to increase the autonomy of the National Bank of Ethiopia, which among other things clarified the role of the National Bank as the regulator and supervisor of the banking sector. Despite improvements in the regulatory framework, the supervisory capacity of the National Bank of Ethiopia remained weak largely due to an acute shortage of qualified banking supervisors. In recent years however, the NBE has made a concerted effort to develop its capabilities over time. As a consequence, the public has gained greater confidence in the banking sector, which has led to strong growth in financial intermediation from levels that were among the lowest in Africa.

Fifth, the government adopted a gradual devaluation policy for the ETB when its value was substantially reduced by 58.6 percent, from \$0.4831 to \$0.20 on October 1, 1992. The government replaced the foreign exchange allocation system from that determined administratively to that determined by auction beginning May 1, 1993. Foreign exchange can be purchased at the auction for current account transactions only and there was a negative list of goods, which cannot be imported through the auction. As a consequence, the value of ETB progressively declined from US \$ 0.4831 in September, 1992 to US \$ 0.0594 to date. Even so, the current account balance has progressively widened and the country's foreign exchange reserve holdings have remained below the prudent level, equivalent to three to four months of imports.

Finally, in January, 1994, the Ethiopian government, reversing the nationalization decision of the Socialist Military Government, issued Proclamation No. 84/1994, to legalize domestic private investment in the banking industry. Following this policy announcement, the following fourteen private banks with a total of 395 branches were established: The licensure applications of another five – Enat, Hawassa, Debub-Global, Noah and Zam-Zam – are currently under review by the National Bank of Ethiopia.

Table 2: Privately –Owned Commercial Banks in Ethiopia

Name of Bank	Year	Branches
1. Awash International Bank	1994	60
2. Dashen Bank	1995	55
3. Wegegan Bank	1997	50
4. **Ba**nk of Abyssinia	1996	47
5. Unite Bank	1998	41
6. Nib International Bank	1999	45
7. Cooperative bank of Oromia	2004	38
8. Lion International Bank	2006	20
9. Zemen Bank	2008	1
10. Oromia International Bank	2008	25
11. Bunna International Bank	2009	8
12. Berhan International Bank	2009	1
13. Abay Bank S. C.	2011	1
14. Addis International Bank	2011	1

With the establishment of the above fourteen private banks, Ethiopia has made good progress in expanding access to financial services. According to the 2010 survey of private commercial banks conducted by Access Capital, privately owned banks have proved to be more efficient and more profitable compared with those that are state-owned. Also according to the same survey, private Banks are well capitalized, and resilient. With a sufficiently strong capital base, profits, and corporate governance, and well-designed systems and controls, the banking sector is well placed to increase its contribution to the growth of the national economy.

Despite the rapid growth of private banks, the following three large state-owned banks continue to dominate the market in terms of deposits and assets. Bank concentration, defined as the asset share of the three largest banks, was 100 percent in 1994 down to 93.6 percent in 1998. It was progressively further reduced down to 69.6 percent in 2006.

Table 3: State-Owned Commercial Banks of Ethiopia

Name of Bank	Year	Branches
1. Commercial Bank of Ethiopia	1963	209
2. Development bank of Ethiopia	1901	32
3. Construction and Business bank	1975	32

According to a 2010 survey of private banks in Ethiopia by Access Capital, Private Banks registered a better performance than state-owned banks. In seven out of nine years, private banks had higher ROA than state-owned banks. According to Kiyota, Pietsch and Stern (2006), the costs of state-owned banks were significantly higher than those for private banks. The ROA of state-owned banks was 1.7 percentage points lower than for private banks. These findings imply that state-owned banks were less efficient than private banks. The inefficiency of state-owned banks is consistent with the findings for other countries (La Porta et al., 2002).

5. Conclusion and Policy Implications

Since coming to power in 1991, the current Ethiopian government has instituted reforms in its banking sector. Although the process has taken two decades, the banking sector remains repressed since the reform process has been painstakingly slow and the policy measures implemented so far are not fully adequate. To date, these measures fall short of significantly improving the banking sector. It is not yet competitive and efficient, nor is it capable of accelerating the economic growth of the country which remains marginal. The government's concern that financial liberalization may lead to a banking crisis that may culminate into an economic crisis is also misplaced. Empirical studies provide evidence that as regulatory and supervisory tools are upgraded and as supervision becomes increasingly vigorous, the probability of a banking crisis significantly diminishes. It is time to recognize this contradiction and it would be wise to begin the process of vigorous reform to achieve financial strength. Global experience suggests that greater competition among domestic and foreign banks can bring greater benefits in the form of improving efficiency. Fundamental market-oriented measures are therefore needed to further strengthen the financial sector in order to accelerate Ethiopia's economic growth.

The policy implications suggest that the Ethiopian banking sector needs to be tuned to the following additional market-oriented reforms in order to benefit positively from the harmonization of financial intermediation with economic growth. These measures include 5.1) the privatization of the dominant state-owned Commercial Bank of Ethiopia; 5.2) permitting entry of foreign banks; 5.3) allowing market forces to determine interest rates and the exchange rate of the ETB, and 5.4) upgrade the regulatory and supervisory ability of the National Bank of Ethiopia to restore the public's trust in the banking sector.

5.1 Privatization of State-owned Banks to Level the Competing Field

Despite the government's decision to allow private domestic banks to be reestablished, reversing the nationalizing policy of the socialist military government, a lion's share of banking business remains dominated by three state-owned banks, the Commercial Bank of Ethiopia, Development Bank of Ethiopia, and the Construction and Business Bank. In the Ethiopian banking sector, loans are not priced competitively by taking into consideration the risk of the borrower and the return of the loan to the lending bank. Instead Ethiopian banks in general follow the loan pricing policy adopted by the Commercial Bank of Ethiopia. In the absence of market forces in the credit market, credit is inevitably directed to inefficient borrowers outside the productive sector of the economy. This practice inevitably denies capital to efficient firms and contributes to the build-up of non-performing loans in the state owned bank's portfolio.

Several studies such as La Porta et al (2002) indicate that the performance of privately owned banks is better than state-owned banks. According to the survey conducted by Access Capita, in Ethiopia bank concentration defined as the asset share of the three largest banks was 100 percent in 1994 and down to 93.6 percent in 1998. It progressed further downward to 69.6 percent in 2006. This implies that the share of government owned banks also declined. According to Kiyatta et al., in seven out of nine years private banks had a higher ROA than state- owned banks. This is due to several factors: the spread has increased for both public and private banks and private banks have higher spreads than publicly owned banks. Therefore, since privately owned banks are superior in terms of efficiency and profitability, publicly owned banks need to be privatized.

5.2 Opening the Ethiopian Banking Sector to Foreign Participation

Despite heavy pressure from the United States Government, as evidenced from Wikileaks messages, the Ethiopian government continues by law to prohibit the entry of foreign banks to the country. Barriers to entry in the banking sector reinforce inefficient state-owned enterprises by shielding them from competition. The government's concern is that if foreign banks were to be allowed to operate in Ethiopia, it may lose of control over the economy. This position is based on the infant industry argument. Prohibiting foreign bank entry at this time would prevent the domestic banks from being weakened because of unfair competition from foreign banks.

Two important questions must be answered when examining the issue of foreign bank entry to Ethiopia. First, will foreign banks invest in Ethiopia if the government reverses its stand and permits their entry? Second, once foreign banks start operations in Ethiopia will they be assets or liabilities to the country? The answer to the first question is an unqualified "yes" since Ethiopia presents a huge potential for bank profits for a number of reasons.

To begin with, foreign banks have a number of advantages compared to domestic banks. By servicing client's active in more than one country, they can achieve benefits from spreading best-practice policies and procedures. Second, they may be able to diversify risk better, allowing them to undertake higher risk, but also with potentially higher returns on investments. Third, foreign banks have advantages in the form of more diversified funding sources, including having access to external liquidity from their parent banks, which may lower their funding costs. Finally, by being larger they may achieve other scale advantages such as utilizing more advanced and sophisticated risk assessment models to give them a competitive edge over fragile Ethiopian banks.

At the same time, foreign banks are likely to incur additional costs and face more obstacles when compared to domestic banks. They may have less information compared to local banks on how to do business in Ethiopia, putting them at a disadvantage, at least until they have been in the country for some time. Moreover, foreign banks might be exposed to discrimination by individual customers. Additionally, diseconomies might arise because of an institutional environment that is culturally different. However, these costs remain a small fraction of the huge revenue benefits they are likely to generate by operating in Ethiopia. As Aghion and Howitt (1998) pointed out, successful foreign banks that have learned to work in a competitive environment with demanding customers in their home countries have learned to innovate, pursue new business segments, and adjust to changing circumstances. Greater competition in their home countries can lead to more efficient operations in Ethiopia. Gregorian and Manole (2006) and Berger, Hansen and Zhou (2009) after examining the role of foreign banks in developing countries have found that foreign banks outperform domestic banks.

The current state of development of the financial sector in Ethiopia is also a factor that could have a favorable impact on the profitability of foreign banks. In Ethiopia, where a large part of the population does not yet have access to banking services, it is easier for foreign banks to gain market share and therefore likely easier to make a higher profit. Finally, according to Berger and Humphrey (1997), size has been found to be an important factor for explaining performance of any bank. By being comparatively larger, foreign banks may achieve other scale advantages; for example they may afford more advanced and sophisticated risk assessment models giving them superior risk management skills.

When studying foreign banks in developing countries, Claessens, Demirguc-and Huizinga (2001) point out that in a country like Ethiopia where the banking sector is inefficient, banking practices are outmoded, and credit is not allocated on commercial criteria, foreign banks may be able to reap higher profits than domestic banks. Similarly Mico, Panizza and Yanez (2007) find that foreign banks do tend to have higher profits than domestic banks in developing countries. Also, Gregorian and Manole (2006) have found that foreign banks outperform domestic banks. The answer to the first question of whether or not foreign banks will be willing to invest in Ethiopia is an affirmative “yes” because it will be profitable for them to do so and globally competitive banks will seek to exploit the profit potential to their advantages.

The answer to the second question, whether or not the participation of foreign banks would be an asset or a liability to Ethiopia, is also clear and unambiguous. Foreign banks will be an asset since they will promote competitiveness and efficiency in the banking sector. However, as far as the current government of Ethiopia is concerned, foreign banks are viewed as a liability to the country. As a consequence, entry of foreign banks is prohibited. The government’s rationale is based on the infant industry argument as follows: First, since the banking sector in Ethiopia is young it will not be able to compete with more mature foreign banks that have more capital, professionally qualified and seasoned managers and employees, and better reputations.

Second, there is evidence in the literature about the association between financial liberalization and banking crises. Such studies include Williamson and Mahar (1998), Kaminsky and Reinhart (1999), Demirguc-Kunt and Detragiache (2001), Weller (2001), Eichengreen and Arteta (2002) and Noy (2004). Demirguc-Kunt and Detragiache (2001) find that financial liberalization is strongly and positively correlated with the probability of a subsequent banking crisis. This is especially true in a country like Ethiopia where the institutional environment is weak. Weller (2001) finds that a banking crisis becomes more likely after domestic financial liberalization. Noy (2004) considers interactions between domestic liberalization and supervision and concludes that banking crises occur as a result of weak supervision after liberalization.

Third, since foreign banks, if allowed to operate in Ethiopia, are likely to engage in cream skimming behavior, preferring large scale operators for clients, such as commercial agriculture, big industrial, real estate and service establishments. They inevitably will skew credit allocation in favor of these very large and established enterprises. Fourth, foreign banks may concentrate on lending rather than mobilizing of savings.

Finally, the government believes that at present Ethiopia is poorly endowed with the financial experts to design and operate the regulatory and institutional structures needed to supervise the banking sector. Although assistance from IMF/World Bank can help redress the shortage, the ultimate success of banking reform ambitions will stand or fall by Ethiopia itself. Ethiopia continues to experience a significant brain drain begun in 1974 and does not have the capability to effectively oversee the operations of foreign banks at this time.

The infant industry argument seems to be an excuse for a concern held by some Ethiopian government officials. According to them, since foreign banks serve as conduits for inward and outward flows they would facilitate the outflow of capital whenever they felt that a banking crisis was about to emerge. An outflow of capital could develop into full-blown economic crises leading to political instability. The government does not want to take chances and lose control. According to Demirguc-Kunt and Detragiache (1998) banking crises tend to erupt when the macroeconomic environment is weak, particularly when growth is low and inflation is high. Since Ethiopia's economy is characterized by low growth and high inflation, the danger of political instability remains real.

Contrary to the government's view, the potential benefits that can result from opening the sector for foreign direct investment remain substantial. First, foreign bank participation may have the potential for a positive impact on the efficiency of the Ethiopian banking sector. Competition demands that domestic banks continuously upgrade their skill and technology levels to stay in business. Second, entry of foreign banks may improve bank regulation and supervision. According to Goldberg (2007) the entry of foreign banks in emerging markets that are healthier than domestic banks implicitly allows the introduction of stronger and more prudent regulation, increasing the soundness of the local banking sector. Third, the entry of foreign banks to Ethiopia will strengthen the financial sector and may have a positive impact on economic growth. Demirguc-Kunt, Levine and Min (1998) and Mattoo, Rathindran, and Subramanian (2006) have found a positive correlation between financial sector openness and economic growth. Also, Beck et al. (2004), Levine, Loayza and Beck (2000) and La Porta (2002), Lopez-Silanes, and Shlefer (2002) concluded that an increase in bank concentration was an obstacle in obtaining financing for growth.

5.3 Allowing Market Forces to Determine Interest Rates as well as the Value of the Ethiopian Birr (ETB)

Eliminating government interference in the banking business is critical for the efficient mobilization of savings and allocation of deposits to profitable enterprises. Examples of government interferences that have disrupted the banking sector include the following: first, the deposit rate on savings is set by the National Bank of Ethiopia. Until December 2, 2010 the deposit rate was 4 percent. Since the inflation rate averaged 19 percent during the last 5 years, the real negative savings rate amounted to 15 percent. Although the National Bank of Ethiopia increased the deposit rate from 4 percent to 5 percent effective December 2, 2010, this move did not lead to a higher level of savings. This would be avoided if all interest rates were allowed to be determined by the market. As a consequence, Ethiopia's savings rate in 2009, according to the World Bank, was 2.3 percent of Gross Domestic Product, which compares poorly to the 25.7 percent rate achieved by Sudan.

Second, the government imposed credit ceilings on private banks, which reduced the volume of credit. This measure contributed significantly to a reduction of the inflation rate, from 64 percent to 2.7 percent. It was removed on April 1, 2011. Third, private banks are now required to offer 27 percent of their loans to the government and do so at an interest rate of 3 percent. This directive is estimated to divert about ETB 11 billion from the private to the public sector. This sum is equivalent to a 2.4 preferment of GDP and is estimated to cover the government budget deficit this year. As a consequence, credit will be tight and expensive.

To enhance the banking sector's ability to mobilize deposits and efficiently allocate savings, all interest rates should be market determined. Currently, the National Bank sets the deposit rate. Although recently NBE has announced its decision to increase the deposit rate from 4 percent to 5 percent, this is still below the level that can allow financial institutions to mobilize deposits and extend credit to support the growth of business and the economy at large. This requires higher interest rates above the inflation rate to make saving a profitable endeavor.

In regard to determining the value of the Ethiopian Birr (ETB), the gradual devaluation policy followed by the government did not prove to be useful. Although it drove down the value of the ETB from US$ 0.4831 in 1992 to $0.0592 in 2011, Ethiopia continues to experience widening current account deficits and rapidly declining foreign exchange reserves. At times the level of the reserve has reached a precariously low level, equivalent to 2 to 3 weeks of imports.

In order to free the exchange rate from the political calculations of the government, and to enhance its flexibility, defining ETB in terms of a basket of floating currencies would lead to a better outcome. In this regard, a basket of four key currencies -- the British Pound, Euro Dollar, Japanese Yen, and the US dollar -- would lead to a better outcome. This approach will indirectly determine the value of ETB based on market forces. The basket composition can be reviewed as needed to insure the relative importance of currencies in the world's trading and financial systems. The weights of the currencies in the ETB basket would be revised based on the value of exports of goods and services and the amount of reserves denominated in the respective currencies which were held by the member countries of the International Monetary Fund.

5.4 Upgrade the Regulatory and Supervisory Capacity of the National Bank of Ethiopia (NBE)

According to several studies, financial liberalization remains a contributing factor to financial crises. However, according to empirical results, this relationship is found to be true only in countries where regulation and supervision are weak. The determining factor for banking crises is not financial liberalization but the quality of the regulatory and supervisory apparatus. The relationship between liberalization and a banking crisis depends strongly on the strength of capital regulation and supervision. The probability of a banking crisis is high in a country with very weak regulation and lethargic supervision. By contrast, the probability of a banking crisis decreases with liberalization in a country with stricter regulation and vigorous supervision.

Despite the government's initiative to upgrade the regulatory and supervisory capacity of the National Bank of Ethiopia (NBE), and gains achieved in improving the quality of NBE's staff, the progress achieved to date remains unsatisfactory. As a consequence, the National Bank's supervisory capacity remains weak. In its recent country report on Ethiopia dated November 2010, the International Monetary Fund "urged the Ethiopian Government to enhance the ability of the NBE to recruit and retain qualified staff to ensure the institutional absorption of the technical assistance provided by the Fund and other partners in this area." With a continuing brain drain significant progress in this area is unlikely to take place in the near term. However, the threat of a banking crisis may embolden the government to continue with its policy of prohibiting foreign bank entry.

On the other hand, the government may give in to pressures exerted by friendly governments and the IMF and the World Bank. Ethiopia's heavy dependence on foreign aid coupled with its desire to join the World Trade Organization (WTO) may prove to be significant motivation for changes in government policies in this regard. Progress in this area will enhance public trust in the banking system and may lessen the possibility of a banking crisis.

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